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Massachusetts Releases Final Market Sourcing Regulations: What You Need to Know

January 21, 2015 ■ 2 p.m. EST

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Agenda

- Overview of New Statute and Regulation Process
- General Considerations
- What's Changed: Working Draft to Final
- Industry Examples
- Throwout
- Timing and Limitations on Amended Returns

Overview of New Statute and Regulations Process

- July 2013 – Chapter 46, Acts of 2013 (HB 3535) – enacts market-based sourcing for tax years beginning on or after January 1, 2014
- March 25, 2014 – Working Draft Regulations Released
- October 30, 2014 – Draft Regulations Released
- January 2, 2015 – Final Regulations Promulgated

General Sourcing Considerations

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General Sourcing Considerations (cont.)

- Multi-Tiered Rules:
 - Provide high-level principles followed by specific rules for how to approximate sales of services sourced to Massachusetts
 - Taxpayers are given a roadmap of the factors to consider and tests to apply for each type of receipt
- Flexibility:
 - More than one correct answer, safe harbors, extrapolation, etc.
- Looking through to third parties:
 - How much data can/must you get from the customer?
- Throwout:
 - Large-scale: Whole categories of receipts get thrown out
 - Small-scale: Sales sourced to a state where taxpayer is not subject to tax under Massachusetts economic nexus rules

What's Changed: Working Draft to Final

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What's Changed – Special Industry Regulations

- Working Draft:
 - Didn't address whether special industry regulations remained in effect
 - But included provisions for delivery and transportation services
- Final Regulations:
 - Pipeline, telecom, and electric regulations remain in full effect
 - Property and payroll provisions in special industry regulations for airlines, motor carriers, and delivery courier services remain in full effect
 - BUT: Sales factor for airlines, motor carriers, and delivery/courier service providers is now governed by delivery and transportation rules in market-sourcing regulations for general business corporations

What's Changed – Safe Harbors

- Prerequisite to using safe harbor: sales from services are not able to be assigned to a particular state or, in some cases, approximated using the Department's tiered rules
- “Safe harbor” provisions allowing certain taxpayers to source professional service receipts and receipts from services delivered electronically based on billing address, regardless of where the services were actually delivered
 - *830 CMR 63.38.1(9)(d)4.c.ii(B)2.d; (d)4.d.iii.(A)3*
- A taxpayer may source receipts based on a customer's billing address if: (1) the taxpayer provides substantially similar services to more than 250 customers; and (2) the taxpayer does not derive more than 5% of its sales from the customer
- Final regulations expanded safe harbor by reducing the threshold from 1,000 customers to 250

What's Changed – Rules of Reasonable Approximation

- Rules of approximation for sourcing receipts when the market for a particular customer is not apparent or known to the taxpayer—approximate based on known sales
- Ability to source “unknown sales” (sales where the taxpayer cannot determine the state of assignment) based on the sourcing method used for “known sales” (sales where the taxpayer can determine the state of assignment)
- Working Draft: Prohibited professional service providers from sourcing based on the geographic location of known sales
- Final Regulation: Professional services permitted to approximate based on known sales; on equal footing with other services
- Professional services include: management services, bank and financial services, financial custodial services, investment and brokerage services, fiduciary services, and lending and credit card services

What's Changed – Limitations on DOR Adjustments

- The final regulations added a circumstance in which the DOR can adjust the taxpayer's method of reasonably approximating receipts
- The Commissioner may adjust a taxpayer's return to more accurately assign sales in the following circumstances:
 - The taxpayer fails to properly assign sales in accordance with the rules set forth in the regulations
 - The taxpayer uses a method of approximation to assign its sales, and the Commissioner determines that the method used by the taxpayer is not reasonable
 - The Commissioner determines that the taxpayer's method of approximation is reasonable, but has not been applied consistently
 - The taxpayer excludes sales from its sales factor because it determines that the assignment of those sales cannot be reasonably approximated, but the Commissioner determines that those sales can be reasonably approximated
 - The taxpayer fails to retain or provide contemporaneous records that explain the determination and application of its method of assigning its sales
 - The Commissioner concludes that a customer billing address was selected for the purpose of tax avoidance

Industry Examples

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- Software Industry
- Financial Institutions
- Electricity/Energy
- Retailers

Industry Examples – Software

- Pre-written software:
 - Prior Rule: Default to TPP
 - New Rule: Default to intangible
- Example:
 - Pre-written software sold to business, installed on New York server
 - 50% of customer employees use software in Massachusetts
- Department View:
 - Deliver by Disk: Tangible personal property – 830 CMR 63.38.1(9)(d)7a
 - Deliver electronically: Intangible property, but sourced using rules for electronically delivered services – 830 CMR 63.38.1(9)(d)5e, 7a
- Can you still treat electronically delivered software as TPP?

Industry Examples – Software (SaaS/Cloud Computing)

- Case study: *Brainshark v. Commissioner* (Software as a Service)
- Regulations: Source to customer location?
- What about location of ultimate recipient?
- Can vendor source sale to location of its own servers hosting the software?

Industry Examples – Software (Maintenance Contracts)

- What rule to apply? Mix of Services, Software and IP
- Upgrades and updates only
 - How is the upgrade delivered?
 - What if delivery of original software different from delivery for upgrade?
- Services only
 - Services delivered remotely
 - Services delivered on-site
- Mixed software and services
 - Predominant use?
 - Unbundle?

Industry Examples – Financial Institutions

- General Rule – Source Receipts Under Financial Institution Apportionment Rules in G.L. c. 63, § 2A(d)
- Catch-All – Source Receipts not Covered by Financial Institution Apportionment Rules under Market-Sourcing Rules for Professional Services
- Interest – G.L. c. 63, § 2A(d)(iii) and (iv) – How is borrower location determined?
- Loan Servicing Fees – G.L. c. 63, § 2A(d)(x)
- Brokerage Fees – source as a professional service – 830 CMR 63.38.1(9)(d)4.d
 - *RS View – source all or a portion to state where trade occurs*

Industry Examples – Electricity / Energy

- General Rule – receipts sourced under special industry apportionment regulation for electricity industry (830 CMR 63.38.10)
- Receipts from Retail Sales of Electricity – 830 CMR 63.38.10(3)(a) – market-based
- Receipts from Wholesale Sales of Electricity – 830 CMR 63.38.10(3)(d) – cost-based
- Hedging / Sales of Futures Contracts – 830 CMR 63.38.10(3)(d) & (e) – hybrid sourcing based on location of order origination (80%) and location of exchange or marketplace (20%)
- Compare with throwout of receipts from sales of “securities” by general business and financial corporations

Industry Examples – Retailers

- Sales of TPP – Destination – 830 CMR 63.38.1(9)(c)
- Receipts from Service Contracts
 - Sourced together with associated TPP?
 - Thrown out?
- Trademark Licensing Receipts – 830 CMR 63.38.1(9)(d)5.b (Marketing Intangible)

Throwout

Throwout

Throwout – Rules

- Sales other than TPP
 - Taxpayer not taxable in state to which sale is assigned
 - *Rarely applicable?*
 - Taxpayer's method of reasonable approximation is determined to be unreasonable
 - Taxpayer cannot determine or reasonably approximate state to which sale should be assigned
 - *Rarely applicable?*
- Sales of intangibles – e.g., partnership interests, securities, goodwill and going concern value
- Sales of patented technology

Throwout – Taxable in Another State

- Look to Constitution and Laws of United States (as interpreted by Massachusetts)
 - Activity in state where activities are protected by P.L. 86-272 [throwout applies]
 - Activity in state that does not extend its taxing jurisdiction to the Constitutional limit [throwout should not apply]
- Application to taxpayers filing combined returns
- Presumption that taxpayer is not taxable if no return filed

Potential Challenges

- Exclusion of receipts from sales factor can produce a mismatch between factors and the tax base
- Examples:
 - Corporation has \$1 million of apportionable income (\$100,000 of operating income and \$900,000 gain from sale of partnership interest)
 - Operating income is derived from sales of professional services to customers in Massachusetts, and other states where corporation files income tax returns
 - Corporation has 10 percent Massachusetts apportionment percentage after throwout of receipts from sale of partnership interest
 - None of partnership property, payroll or sales were in Massachusetts
 - Does apportionment of \$100,000 of income to Massachusetts constitute distortion under *Norfolk & Western* and *Hans Rees*?

Timing and Limitations on Amended Returns

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Limitations on Amended and Future Returns

- Amended returns – changes to method of assigning sales generally not allowed
 - Exceptions – factual and calculation errors
 - Limitation exceeds Department’s statutory authority
 - Audit adjustments by Department still permitted
- Prospective changes – permitted – but only if changes increase “accuracy”
 - General requirement to apply methods of reasonable approximation consistently from year-to-year
 - Disclosure
 - Record retention

Questions?

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About Reed Smith's Massachusetts Tax Practice

Reed Smith's Massachusetts tax practice is built on more than 15 years of experience in Massachusetts state tax planning and controversy matters, focusing on income and sales and use taxes. The Reed Smith Massachusetts tax team writes and speaks frequently on Massachusetts tax issues, and handles significant Massachusetts tax appeals for some of the nation's largest companies.

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